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April 7, 1998

APR 1998
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BY HAND DELIVERY

Mr. David Guzy
Chief, Rules and Publications Staff
Royalty Management Program
Minerals Management Service
Building 85
Denver Federal Center
Denver, Colorado 80225

Re: Comments on Proposed Crude Oil Valuation Rule

Dear Mr. Guzy:

Enclosed are two copies of the comments of Mobil Oil Corporation to the Minerals Management Service's February 6, 1998, Federal Register notice captioned "Establishing Oil Value for Royalty Due on Federal Leases." Please file one copy and date-stamp and return the other copy with our messenger.

Sincerely,

Suzanne M. Bonnet

Enclosure

APR 1998
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COMMENTS OF MOBIL OIL CORPORATION
April 7, 1998
on "Establishing Oil Value for Royalty Due on Federal Leases"
Department of the Interior
MINERALS MANAGEMENT SERVICE
63 Fed. Reg. 6113, February 6, 1997

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Mobil Oil Corporation ("Mobil") submits these comments in response to MMS' Second Supplemental Notice captioned "Establishing Oil Value for Royalty Due on Federal Leases," published February 6, 1998, in the Federal Register ("Supplemental Notice").

INTRODUCTION

The Supplemental Notice makes several significant changes to the proposed crude oil valuation rule originally published in the Federal Register on January 24, 1997, and supplemented on July 3 and September 22, 1997. MMS proposes to reduce the number of transactions that would or could be valued for royalty purposes using a proposed index method. Under the Supplemental Notice, if some crude oil *ultimately* is sold at arm's-length -- no matter how far removed from the lease and without regard to whether the lessee or an affiliate has previously parted with federal barrels under an exchange or buy/sell agreement -- it must be valued for royalty purposes on the gross proceeds accruing to the seller under the arm's-length sale, less MMS-allowed deductions for location, quality and transportation. MMS no longer uses this "gross proceeds" concept in its traditional role at the lease but rather now looks to downstream gross proceeds to value the crude oil. In effect, this downstream gross proceeds proposal, especially when combined with the proposal's tracing requirements for buy/sells or exchanges, will require a lessee or its affiliate, as appropriate, to do the impossible -- to trace crude oil barrels through a series of transactions -- often involving separate entities and affiliates -- or to treat vastly different types of crude oil as if it were federal royalty oil. This proposal will add tremendous uncertainty to the valuation process and additional administrative and recordkeeping burdens to federal lessees. Most importantly, this new proposal misapprehends the traditional reason for using gross proceeds as a valuation method, which is to reflect value *at the lease.* Gross proceeds on a downstream sale, particularly a downstream sale of different crude oil under different economic circumstances, will not reflect the lease market value of crude oil from federal leases.

For crude oil not sold at arm's length, the Supplemental Notice maintains the concept of index pricing, merely substituting spot market prices for NYMEX prices as the starting point for valuing the crude oil. The Supplemental Notice also purports to subdivide the country into three geographical areas, each with its own basis for valuing crude oil not sold at arm's-length. Substituting a spot market price for a different index price or one spot price for another does nothing to alleviate the problems that Mobil has noted before with regard to the use of reference prices.

Rather than improving the proposed rule, the Supplemental Notice compounds its shortcomings, and in fact, renders it virtually unworkable. Fundamentally, the current proposal does not address the core concerns raised in

Comments of Mobil Oil Corporation on Proposed Rules Establishing Oil Value for Royalty Due on Federal Leases, and on Sale of Federal Royalty Oil, dated May 28, 1997 ("Original Comments"), as supplemented on August 4 and again on November 5, 1997. Mobil explained in detail why requiring an index methodology in this context is economically unsound, inappropriate, and discriminatory. Computing royalty value on the basis of a market center netback methodology or a netback methodology that starts with gross proceeds from downstream arm's-length sales will be no more reflective of lease market value than the flawed NYMEX methodology contained in the original January 24, 1997 proposal. Furthermore, the Supplemental Notice, like the original proposed rule, still discriminates against vertically integrated companies and will result in variable treatment of similarly situated lessees.

At best, MMS misapprehends crude markets. At worst, it exceeds its statutory authority by attempting to capture value added by downstream crude marketing efforts. Along the way, the Supplemental Notice imposes new and additional regulatory burdens on integrated companies such as Mobil by requiring calculation of pipeline costs on existing pipelines reminiscent of now substantially abandoned regulatory structures once administered by the Federal Energy Regulatory Commission ("FERC"). None of the statutes under which MMS purports to promulgate the Supplemental Notice contains any authority for such action. Rather than "develop[ing] valuation rules that better reflect market value, and add[ing] more certainty to valuing oil produced from Federal lands," 1/ MMS' stated purpose, the Supplemental Notice presents a burdensome and virtually unworkable valuation methodology. Therefore, Mobil reaffirms and incorporates by reference its comments (including all exhibits thereto) submitted in response to the original proposed rule on May 28, 1997, and the supplementary proposed rule on August 4 and November 5, 1997. Mobil also adopts and incorporates by reference the comments contained in the report of the Barents Group L.L.C., "Analysis of The Department of Interior, Minerals Management Service's Supplementary Proposed Rule Establishing Oil Value for Royalty Due on Federal Leases," dated April 7, 1998, as well as the Barents Group's "Analysis of MMS' 'Economic Analysis of Proposed Federal Oil Valuation Rule Under Executive Order 12866,'" dated April 7, 1998, both of which are being submitted to MMS. In addition, Mobil adopts and incorporates the comments submitted by the American Petroleum Institute and Western States Petroleum Association, dated April 3, 1998, regarding the proposed rule and Supplemental Notice. Finally, Mobil makes the following additional comments on specific changes in the Supplemental Notice.

1/ 63 Fed. Reg. 6113.

I. THE SUPPLEMENTAL NOTICE IS FUNDAMENTALLY FLAWED

A. MMS Has Failed to Justify its Abandonment of Lease Market Benchmarks for Royalty Valuation.

As Mobil pointed out in its Original Comments, under the Administrative Procedures Act, 5 U.S.C. § 301 *et. seq.*, agency rulemaking is unlawful and will be set aside if its findings and conclusions are "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law." *Id.* § 706(2)(A); Original Comments at 65-67. Accordingly, an agency's explanation of the basis for its decision must include a "rational connection between the facts found and the choice made." *Bowen v. American Hosp. Ass'n,* 476 U.S. 610, 626 (1986). Furthermore, an agency's rulemaking must be "[ ]supported by substantial evidence." 5 U.S.C. § 706(2)(E); *Citizens to Preserve Overton Park, Inc. v. Volpe,* 401 U.S. 402, 414 (1971). "[A] 'rule without a stated reason is necessarily arbitrary and capricious.'" Original Comments at 66, *citing National Recycling Coalition, Inc. v. Browner,* 984 F.2d 1243, 1252 (D.C. Cir. 1993) (citation omitted).

In its Original Comments, Mobil noted that MMS has failed, as a threshold matter, to justify its move away from lease market benchmarks for valuation of crude oil. *See* Original Comments at 14-17. Nothing in the current proposal addresses that fundamental point. It has been and is Mobil's consistent position that comparable transactions *at the lease* are the proper primary determinant of royalty value. *See, e.g., id.* at 6-10. The Supplemental Notice, however, proposes to use gross proceeds from a downstream sale as the starting point for royalty valuation, regardless of whether the sale is of crude similar to federal royalty oil or of a vastly different crude. This approach rests on the unsupported assumption that proceeds received in *any* arm's-length sale, less certain MMS-specified costs, will closely approximate the value of federal royalty oil at the lease, regardless of where the sale takes place, what crude is sold, and without consideration of the value added by the crude marketer. This assumption is flatly wrong. MMS' conclusion that there are few lease-level transactions is not supported by the rulemaking record. In fact, there are thousands of lease-level transactions that could be used to determine market value based on comparable sales of similar crude oil in the field, the valuation method traditionally favored by the courts and used by MMS. *Id.* A downstream sale, especially of a vastly different crude oil, is not, however, a valid indicator of lease-market value. MMS' effort to specify allowable cost deductions that will supposedly allow a netback price are wholly inadequate and do not begin to account for the numerous differences between sales transactions at downstream points and at the lease.

B. The Use of Gross Proceeds To Value Crude Sold in a Downstream Arm's-Length Sale is Inappropriate.

The current proposal marks a dramatic change in the calculation of royalties due on oil produced from federal leases. As a practical matter, this change will benefit few lessees while burdening many more. The Supplemental Notice requires lessees or their affiliates to trace crude oil barrels through a series of transactions back to the individual lease, and to attempt to segregate the federal barrels from other barrels of crude oil even when those barrels have been delivered to a common-stream pipeline. This is virtually impossible to do. While a lessee may know at the lease whether particular crude oil is from a federal lease, once a barrel moves off the lease and is commingled with other barrels, neither the lessee nor its affiliates, as defined by the proposed rule, have any way to distinguish between federal and non-federal crude oil or between barrels sold at arm's-length from those not sold at arm's-length.

This problem is compounded by the manner in which the gross proceeds provision operates. A hypothetical will illustrate the point. Suppose a lessee produces 600 barrels of Louisiana Light Sweet (LLS) crude oil from a federal offshore lease subject to a one-sixth royalty obligation. The lessee, or its affiliate, brings that crude onshore at St. James and promptly enters into a buy/sell agreement with another, unrelated entity. Under the buy/sell, the lessee or its affiliate receives West Texas Intermediate (WTI) at Cushing, Oklahoma. If the lessee or its affiliate then sells the WTI in an arm's-length sale, it must treat the gross proceeds received on 100 barrels of the sale of the WTI as the starting point for determining royalty valuation and then netback to the lease using the specified location and quality differences permitted by the Supplemental Notice. MMS has never explained why this approach even remotely approximates the value of LLS at the lease, which is the value to be determined. As a matter of economics, the "gross proceeds" under this methodology will match crude value at the lease only by coincidence. MMS does not address that problem. Indeed, the Supplemental Notice provides no economic analysis that would support MMS' approach.

This is an overly simple hypothetical. Real market transactions are likely to be more complicated, with, for example, some of the WTI at Cushing (from the above hypothetical example) being traded for another domestic sweet grade, some traded for West Texas Sour, and some traded for foreign crude. Tracing these barrels through a series of transactions is impossible, and implementation of the "weighted average" volume methodology of multiple arm's-length sales to compute royalty value creates additional layers of complexity and a high degree of uncertainty in determining value.

Furthermore, like the index methods discussed below and in Mobil's previous comments, the "gross proceeds" proposal -- which does not allow all appropriate deductions, in any event -- is an improper attempt to capture value added to crude oil by downstream marketing efforts. Because MMS would allow only its minimal definition of costs to be deducted from the gross proceeds received at the downstream sale, the proposal does not account for real costs and investments between the lease and any point downstream. Accordingly, a lessee or its affiliate's entire crude marketing operation remains subject to royalty under the Supplemental Notice.

C. MMS' Definitions of "Non-Arm's-Length Transaction" and "Affiliate" are Overbroad

The current proposal does nothing to amend MMS' overbroad definition of non-arm's length transactions. In that regard, the theoretical underpinnings of the Supplemental Notice remain conceptually defective, resting as they do on the erroneous and unsupported notion that vertical integration within the oil industry and reciprocal dealings among oil companies are inherently anticompetitive. *See* Original Comments at 22-25, 27-32, 41-57.

Additionally, without explanation, the Supplemental Notice modifies the current definition of an affiliate. Under the Supplemental Notice, any "person who owns, is owned by, or is under common ownership with another person to the extent of 10 percent or more of the voting securities of an entity, interest in a partnership or joint venture, or other forms of ownership" is considered an "affiliate." 63 Fed. Reg. 6126. Thus, MMS irrebutably presumes that a ten percent ownership interest constitutes affiliation without regard to an entity's actual ability to control its so-called affiliate.

This overbroad definition both ignores economic reality and imposes substantial costs and burdens upon lessees. For example, the Supplemental Notice would require that "affiliates" share information with the lessee so that crude oil barrels may be traced through unlimited transfers to the ultimate point of arm's-length sale. This requirement creates a number of practical problems. First, by creating an irrebutable presumption of affiliation when a lessee has a ten percent interest in any other entity, the Supplemental Notice effectively assumes that the lessee exercises sufficient control over the putative affiliate to obtain the information necessary to comply with the rule. There is no basis for that assumption; in fact, it defies common sense, the reality of governance of business enterprises, and ordinary precepts of corporate law. Second, even assuming that the first problem can be overcome, lessees are likely to encounter great, if not insurmountable, difficulty in complying with the Supplemental Notice's recordkeeping requirements when the pertinent information is in the hands of an affiliate who is a separate legal entity. Affiliates often have separate recordkeeping, accounting and administrative systems. In most cases, these computer and recordkeeping systems are not integrated, and personnel from different affiliates have little knowledge of the operations of the other. Third, this information exchange would raise a myriad of significant legal issues, including antitrust issues, as lessees will be forced to share competitive pricing information with so-called "affiliates." MMS' unexplained abandonment of the language of the 1988 regulation, which reflects a sensible and fair control approach, 2/ is all the more puzzling given that it has retained the 1988 definition in its proposal regarding valuation of crude oil on Indian lands. 3/ In any event, MMS has not

2/ 30 C.F.R. 206.101 (1988).

3/ 63 Fed. Reg. 7089, 7099 (February 12, 1988).

articulated a rational basis for its modification of the term "affiliate" or for its narrow conception of arm's length-transactions.

D. Use of Indexing Method to Value Crude not Sold at Arm's-Length.

For crude oil not sold at arm's-length, the Supplemental Notice envisions using a netback methodology similar to that set forth in the original proposed rule, but starts from a different reference price depending upon the geographical location of the lease. The indexing method would apply to all production not sold at arm's-length including production subject to a "non-competitive crude oil call," and production sold when the lessee or affiliate and the purchaser are found to have an overall balance agreement, a concept that MMS nowhere explains or defines. *See* 63 Fed. Reg. 6117 ("[I]f an 'overall balance agreement' is found to exist, you would be required to value production under [the indexing method] or the total consideration received, whichever is greater."). In recognizing the shortcomings of imposing a single spot or futures market on virtually all domestic production, MMS has made a small gesture toward improving the proposed rule. In other relevant respects, however, the Supplemental Notice suffers from the same problems that Mobil has noted with regard to the original NYMEX-based netback proposal.

As Mobil has previously explained, under the governing federal law, *any* netback method of valuation is appropriate only as a last resort when other, more appropriate benchmarks are not available. *See, e.g.*, Original Comments at 10-11. Transactions at the lease will reflect different supply and demand factors and will be vastly different from transactions at market centers or in the ANS spot market. For that reason alone the rule was originally and remains fatally flawed. *See id.* Furthermore, there is no evidence in the rulemaking record to suggest that all crudes are traded on a spot market, which raises serious doubts about the representative validity of spot market prices. *See id.*.

1. Proposed Geographical Divisions

Because the Supplemental Notice is fundamentally defective, the alterations from the original proposed rule amount to little more than tinkering. In the abstract, the concept of a geographical division for valuation purposes may seem logical, as the areas identified by MMS are, in fact, quite distinct. Such a division will add yet another layer of complexity to royalty valuation, however, which will be further complicated and uncertain especially in those instances when production from leases in different geographical areas is commingled. The Supplemental Notice does not contemplate such transactions, which again illustrates the flaws in MMS' approach. Most fundamentally, the rulemaking record compels the conclusion that all crude oil markets are inherently local and subject to their own supply and demand factors. *See* Original Comments at 10-14 (citing testimony of Joseph P. Kalt, Ph.D, in *Engwall v Amerada Hess Corp.*, No. CV-95-322 (5th Dist., Chaves County, New Mexico) at 1116-17, 1143, 1177, 1190-92). Thus, while crude oil produced in the Rockies is subject to different market forces than crude oil produced in other parts of the country, it does not follow that the "Rocky Mountain Area" as now defined constitutes one single market.

2. Production from California and Alaska Area

For California and Alaska production, MMS proposes to use ANS spot prices as the basis for royalty valuation. As Mobil has previously commented, MMS has never articulated any economic explanation for why royalty valuation for California crude oil should be based on spot market prices for a water-borne crude oil that may be lighter than California crude by as much as 15-degrees API. California and ANS crude have vastly different physical properties and qualities. *See* Comments of Samuel A. Van Vactor ("Van Vactor Comments"), dated March 21, 1998. Even within a region -- much less between regions -- it is difficult to derive a price for crude oil from one field by comparing it the price of crude oil from a different field. *Id.* The Van Vactor Comments illustrate this point. Using crude oil posted price bulletins in California, which account for differences in crude oil quality using API gravity factors and sulfur content, the Van Vactor Comments compared crudes from several fields in California. The comments conclude that, even adjusting for those two quality differences, one could not arrive at market value for crude oil from one field by analyzing the sales/price data for crude oil from a different field. Rather, factors that influence price are field-specific. *Id.* Comparisons of California crude oil with Alaska crude oil will be even more difficult. The Van Vactor Comments conclude that "whenever possible, MMS should avoid calculating [royalties] using indexes or proxy crude-oil prices, because these proxies can deviate from fair market value in unpredictable ways." *Id.* The Supplemental Notice, like the proposed rule, wholly ignores the differences between California and Alaska crude oil and makes no valid attempt to adjust for variations in quality between them. This will inevitably introduce substantial error into royalty valuation. As a result, MMS proposes to collect royalty on the value of something other than production "saved, removed or sold," 43 U.S.C. § 1337(a)(1)(A) & (B), from the federal lease in violation of the governing statutes. Actual lease market transactions are the appropriate measure of crude oil value.

3. Production from Rocky Mountain Area

For the Rocky Mountain Area, now a defined term, MMS proposes a valuation hierarchy with four alternatives. In principle, a tendering alternative could be acceptable in that the royalties collected under this method would not include the value of downstream marketing efforts. The tendering proposal in the Supplemental Notice, however, creates artificial constraints and inappropriate thresholds that impede its effectiveness. For instance, the requirement that a lessee offer and sell at least 33 1/3 percent of its production from both federal and non-federal leases in that area is supposed to prevent "gam[ing] the system." 63 Fed. Reg. 1619. The rationale for this fear is never explained, although it apparently rests on the discredited notion that reciprocal transactions, such as buy/sells or exchanges, are not arm's-length transactions. Mobil has previously noted that crude oil exchanges and buy/sell agreements are a long-standing petroleum industry practice and are uniformly recognized as procompetitive. *See, e.g., Blue Bell Co. v. Frontier Refining Co.,* 213 F.2d 354 (10th Cir. 1954), and other cases cited in Mobil's Original Comments at 28.

MMS' stated justification for use of the 33 1/3 figure is simply illogical. MMS chose this figure "because it exceeds the typical combined Federal royalty rate and effective State tax and royalty rates for onshore oil leases by roughly ten percent." 63 Fed. Reg. 6119. The choice of ten percent is not explained and appears to be arbitrary. In any event, the combination of state royalty and tax rates and federal royalty rates is illogical because a lessee would never pay both state and federal royalties on the same crude oil.

The most fundamental flaw in this provision, however, is MMS' vague use of the term "area" throughout this provision. It is unclear whether all references to the "area" mean the Rocky Mountain Area or whether some references to an "area" mean something different, for instance, "a geographic region at least as large as the limits of an oil field, in which oil has similar quality, economic, and legal characteristics." *See* 63 Fed. Reg. 6126. Assuming that the references to the "area" refer to the Rocky Mountain Area, requiring three bids from bidders without their own tendering program that cover all or some of the same area may be a practical impossibility and may well defeat this alternative entirely. There are a limited number of crude oil purchasers in the Rocky Mountain Area and thus a limited number of eligible bidders. MMS is requesting comments on whether it should limit qualified bids to those with tendering programs anywhere, which would make this requirement even more onerous. MMS' concern that lessees may "game the system," 63 Fed. Reg. 6119, has caused it to design a system that is so restrictive as to be self-defeating.

The second alternative, using the volume-weighted average gross proceeds accruing under arm's-length sales, suffers from the shortcomings noted above in Sections A and B. The third method based on the NYMEX price suffers from the flaws that Mobil has enumerated in its Original Comments at Section II.B. The fourth alternative would be established by the MMS Director when use of the enumerated alternatives would not result in a reasonable valuation in a particular situation. MMS has given no indication of the process it would employ in arriving at a valuation in any particular instance. As a practical matter, Mobil does not believe this alternative presents a workable valuation method.

4. All Other Crude Production

For production outside of the Rocky Mountain Area and California and Alaska, MMS proposes to use average daily mean spot prices (published in an MMS-approved publication) derived at market centers nearest the lease for the same or similar crude, less applicable allowances. The change to spot rather than NYMEX prices is, in Mobil's view, cosmetic only, and does not address the core problems underlying use of netback pricing methodologies generally. *See* Original Comments at 12 n.9 (citation omitted). Spot sales of crude oil at market centers are not representative of lease market prices or of crude oil value at the lease. Moreover, as noted above, not all crudes are traded on a relevant spot market. For those that are, reported spot prices may not be reliable, as Mobil noted in its Original Comments, for many reasons, among them: (1) the number of transactions may be statistically too small; (2) there is no uniform method for calculating spot market averages; and (3) the accuracy of reports in trade presses depends heavily on the individual journalist. *See id.* MMS cannot insure the accuracy of the reporting in any of the publications that it approves.

Furthermore, the deductions allowed for location, quality and transportation are inadequate to reflect real quality differences in crude oil, and wholly ignore the costs and risks incurred in bringing crude oil downstream to a market center. *See infra* Section E. The Supplemental Notice would require lessees and their affiliates, some over which they have no control, to submit differential information between aggregation points and market centers. MMS proposes to calculate location/quality differentials between market centers and aggregation points just once a year. In reality, the market fluctuates constantly based on changes in local supply and demand factors. The MMS differentials will not be reflective of current market conditions and cannot therefore be the proper adjustments. This imposes significant costs and uncertainties on lessees.

E. The Proposed Rule Improperly Attempts to Ascribe Value Added to Crude Oil by Downstream Marketing Efforts and Ignores Actual Costs Incurred by the Lessee.

MMS continues to assume erroneously that the price of crude oil at a spot market is equal to the price at the lease plus some definable cost that, when subtracted, will "net back" to the lease. Thus, while the proposed spot market indexing method represents a change in the starting point from the previous NYMEX-based methodology in the original proposal, one thing remains the same: it still does not and cannot account for all costs incurred between the lease and the market center, the arbitrary reference point MMS now proposes to use. *See, e.g.,* Original Comments at 17-22. In that regard, this valuation method still impermissibly captures value added to crude oil downstream of the lease, including, *inter alia,* marketing efforts such as risk and return on investment, *id.* at 17-20, and aggregation of volumes, blending of crude, storage and inventory costs, scheduling costs, overhead costs associated with transportation and the like, *id. at* 20-22.

Furthermore, as Mobil noted in its Original Comments, MMS' assertion that a federal lessee has a duty to market crude oil at no cost to the lessor is unfounded. *See* Original Comments at 57-63. An MMS regulation cannot create a new obligation that exceeds MMS' statutory authority, and there is currently no obligation in the governing statutes, the 1988 regulations or otherwise on a lessee to market the lessor's crude oil at all, much less at no cost to the lessor. *Id.* Under existing regulations, federal lessees have an obligation to place crude oil in marketable condition at no cost to the lessor. 62 Fed. Reg. 3753. The obligation to put crude oil production in marketable condition, however, does not translate into a generalized duty on the part of a lessee to market crude oil for the lessor.

Mobil remains of the view that the current regulations adequately and properly use posted prices and comparable transactions at the lease as the appropriate benchmarks for valuing crude oil not disposed of in arm's-length transactions. An active market exists for oil at the lease that can be used to calculate royalties. In the alternative, Mobil reiterates its view that MMS should take its royalty in kind. A properly structured royalty-in-kind program would meet MMS' legitimate regulatory goals without the unnecessary burden imposed by the original proposed rule or the Supplemental Notice. Indeed, in view of pending legislation, which would mandate that the federal government take its royalties in kind rather than in value, it would be most ineffective and improper for MMS to push forward with its current proposals.

F. The Proposed Rule Continues to Draw An Improper Distinction Between Vertically Integrated Firms and Other Federal Lessees.

The Supplemental Notice does nothing to remedy the Proposed Rule's discrimination against entities vertically integrated into transportation and refining. Indeed, if anything, it exacerbates the problems created by the original proposal. For example, when adjusting for transportation costs, lessees using the index method of valuation may only deduct actual transportation costs as defined by MMS. When a lessee's pipeline affiliate transports for other, non-affiliated lessees -- either other integrated firms or independents -- those lessees would be able to deduct FERC-approved tariffs fully, while the affiliate may not. Thus, the MMS transportation deduction will result in different royalty valuation of identical crude oil barrels based solely on the identity of the lessee and whether that production is transported on the pipeline owned by the lessee's affiliate. This discriminatory treatment is economically irrational and has no basis in the statutes governing royalty collection by MMS.

The cost-based requirements will also impose a substantial burden on Mobil and other integrated companies that is wholly unrelated to any royalty collection purpose. Pipeline regulation is properly the domain of FERC, not MMS. Existing FERC regulations have substantially eliminated the need for Mobil and other companies integrated into the transportation of crude oil to maintain the extensive cost-accounting information required by the Supplemental Notice for existing lines. Limiting transportation deductions to actual costs would, under the guise of royalty valuation, reimpose on lessees who happen to be affiliated with pipeline owners the burdens of cost-based regulation that FERC itself has substantially abandoned for these same lines. MMS' statutory authority simply does not permit it to exercise such quasi-regulatory authority over pipeline operations. Finally, the limitation of deductions to actual costs makes no allowance for return on the substantial, depreciated capital investment Mobil has made in various pipelines. This limitation unquestionably discriminates against similarly situated lessees based on whether a lessee is affiliated with a pipeline company. That result creates a disincentive for integrated companies to invest in, construct and operate transportation systems of its own. As Mobil has previously noted, such a rule will very likely create perverse incentives for lessees to dispose of their crude oil in a fashion that legitimately minimizes the regulatory extraction of their profits, but which may not inure to the benefit of the public. *See* Original Comments at 32.

G. The Provision Regarding MMS Guidance on Valuation is Impermissibly Vague

In Section 206.107 of the proposed rule, MMS purports to give lessees an opportunity to obtain guidance on determining value and an opportunity to propose a valuation method to MMS. The provision's vague language, however, renders it virtually useless. It provides that a lessee may:

> propose a valuation method to MMS. Submit all available data related to your proposal and any additional information MMS deems necessary. MMS will promptly review your proposal and provide you with a non-binding determination of the guidance you request.

MMS fails to provide any definition of the key terms in this provision. For instance, the term "promptly" should be defined, or at least, some guidelines should be provided so that a lessee could know with some degree of certainty when it could expect a response from MMS. Mobil, for example, has had a value determination outstanding since September of 1996. Additionally, existing regulations do not specify that value determinations are non-binding. MMS has offered no explanation for this change. As a practical matter, a lessee would not seek a non-binding value determination. If the determination is favorable, MMS would not be bound by it in any event. If the determination is unfavorable, the lessee might be at risk for willful and knowing non-compliance if it disregards the guidance, since MMS's interpretation of its valuation rules will then be known; yet, the lessee has no recourse to appeal.

II. THE SUPPLEMENTAL NOTICE IS PROCEDURALLY FLAWED

A. Reauthorization of Form MMS-2014.

Mobil adopts and incorporates by reference the comments contained in the report of the Barents Group L.L.C., dated March 6, 1998, and submitted to the Office of Management and Budget ("OMB"), regarding the reauthorization of Form 2014. The Barents Report demonstrates that MMS has significantly underestimated the burden lessees will bear in completing Form MMS 2014 under the Supplemental Notice. In fact, MMS' estimate is replete with mathematical errors. As the Barents Report concludes, MMS should correct these mathematical errors and publish a revised estimate, and then analyze the impact of the proposed crude oil valuation rule on the burden imposed by Form MMS 2014 before the information collection is reauthorized for the full three years requested.

B. Form 4415.

The revised Form MMS 4415 does not significantly change the overly burdensome reporting requirements of the original proposal to which Mobil objected. Furthermore, MMS has not met the concerns of OMB, which previously withheld approval of the form. Mobil adopts and incorporates by reference the comments contained in the report of the Barents Group L.L.C., dated March 10, 1998, and submitted to OMB, regarding Form MMS 4415. The Barents Report demonstrates that proposed Form MMS 4415, even as revised, is burdensome, costly and does not meet MMS' own objectives. It further demonstrates that the revised form still fails to meet the standards of the Paperwork Reduction Act, 44 U.S.C. § 3501, *et seq.*

C. The Proposed Rule Violates Certain Executive Orders.

The Supplemental Notice does nothing to remedy the fact that the proposed rule would indeed deprive lessees of their constitutionally protected property rights when royalties are paid based on a price that is higher than actual lease sale prices -- *i.e.*, a price that is impossible for lessees to actually realize and that includes returns on investments and downstream marketing profits. *See* Original Comments at 38-39. Because such a taking will occur if the proposed rule is approved, *see infra,* MMS must prepare a Takings Implication Assessment pursuant to Executive Order 12630. *See* 63 Fed. Reg. 6124.

Additionally, the Department of the Interior continues to err in its estimate of the cost of the proposed rule. *See supra* II.B.; Report of Barents Group L.L.C., dated March 10, 1998, and submitted to OMB, regarding Form MMS 4415. Thus, MMS' statement that the proposed rule "will not have a significant economic effect" within the meaning of Section 3(f)(4) of Executive Order 12866 continues to be erroneous. 63 Fed. Reg. 6124. Mobil also continues to dispute the Department's certification for purposes of the Unfunded Mandates Reform Act of 1995 that "this rule will not impose a cost of $100 million or more in any given year on local, Tribal, or State governments, or the private sector." *Id.*

D. MMS is Acting Outside the Scope of its Statutory Authority

The fundamental problem with the Supplemental Notice, as well as with the proposed rule generally, is the intent and effect to capture a royalty on value added to crude oil downstream of the lease. Because federal ownership of mineral rights involves physical property rights *in situ* only, *see* 30 U.S.C. § 226, a federal royalty will be the lessor's share of production free of *production* costs. *See, e.g., Heritage Resources, Inc. v. NationsBank,* 939 S.W.2d 118 (Tex. 1996); *see generally* Original Comments at Section V and cases cited therein. MMS is simply without statutory authority to require payment of royalty on value added by downstream marketing efforts.

E. The Proposed Rule Is Constitutionally Infirm

As Mobil noted in its Original Comments, federal lessees have a constitutionally protected property interest in their leases. *See* Original Comments at 67 (citing *Continental Oil Co. v. United States,* 184 F.2d 802 (9th Cir. 1950)). MMS' attempt to capture downstream profits through administrative rulemaking constitutes constitutes a "taking" in violation of the Fifth Amendment. If MMS wishes to obtain downstream profits, it has two options: (1) attempt to negotiate leases with producers that would require them to market downstream and to pay royalty on downstream prices; or (2) take its royalties in-kind and market the crude oil itself. MMS cannot simply "take" the downstream profits without affording lessees due process and just compensation.

CONCLUSION

Mobil appreciates the opportunity to comment on the Supplemental Notice. The current proposal does not address the core concerns Mobil raised in its comments to the original proposed rule and prior supplemental revisions. By requiring lessees to netback from downstream transactions to arrive at a royalty value, the Supplementary Notice will geometrically increase both the points of decision for valuation of crude and the points of potential controversy between the federal government and its lessees. The result of this scheme is greater uncertainty and loss of the trust relationship between lessor and lessee. Mobil remains of the view that MMS should withdraw and rethink its proposal.